Observations - June 2021 - Tandem Investment Advisors

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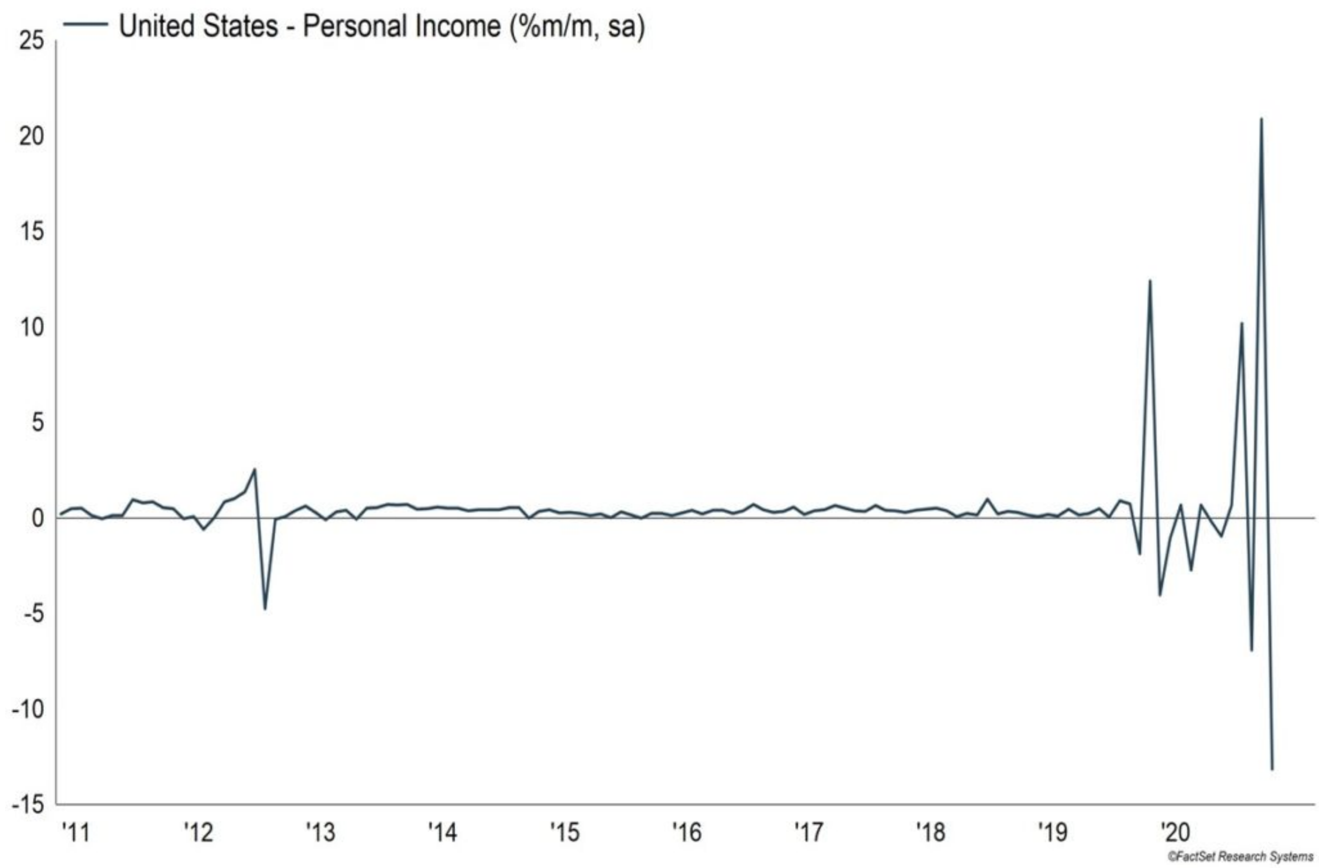
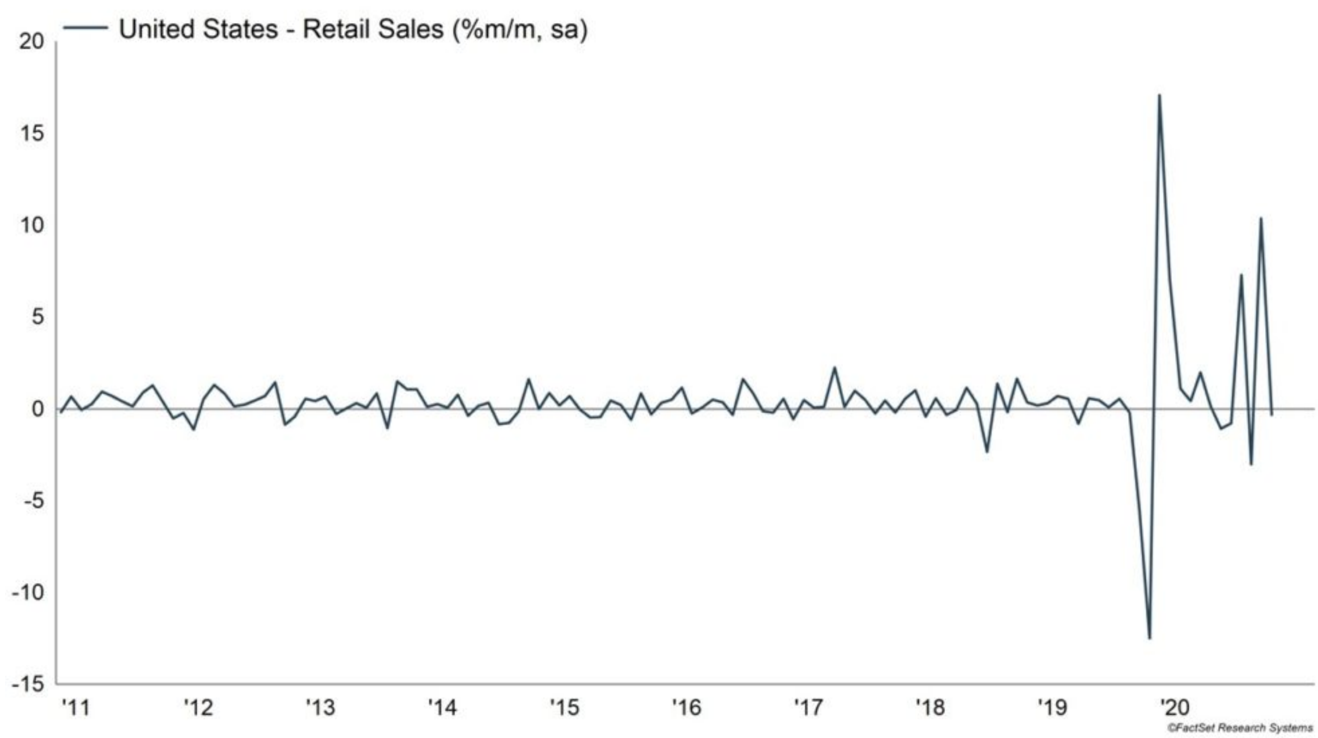
by William “Billy” L. Little, Jr., CFA

Financial Markets Review

The broader U.S. equity and fixed income markets have managed to tread water since mid-April. Over the past six weeks, the S&P 500 has advanced 0.45%, while U.S. Treasuries, ranging from 2-year to 30-year maturities, have barely moved. Now that Q1 earnings season is largely behind us and additional fiscal stimulus talks have seemingly stalled, financial markets are able to take a much-needed breather.

After a 90+% rebound in the S&P 500 off the March 2020 lows, and with much of the country opening back up, a pause that refreshes is probably the most desirable outcome for markets right now. Everything has moved so fast and been volatile over the past 15 months, that it has been impossible to get a sense for what is real and what is sustainable. For instance, the month-over-month percentage changes in much of the consumption and personal income data continue to be so volatile that getting an accurate read on the consumer is futile. The charts below of Personal Income and Retail Sales put the volatile nature of the data into perspective when compared to the previous 10 years.





Meanwhile, the U.S. Dollar Index has declined roughly 2% and the Bloomberg Commodity Index has risen over 7% since mid-April, which has kept inflation on the forefront of everyone's mind. The most recent inflation readings show year-over-year increases of 4.2% in CPI, 6.1% in PPI and 3.6% in PCE and have done very little to cool current inflation worries. In fact, as nominal Treasury yields have stabilized, real yields across the entire curve have continued trending deeper into negative territory. In a nutshell, negative real rates are a sign that inflation expectations are outweighing those of growth expectations. The fixed income market is not anticipating a new era of growth, but more than likely an economy that climbs back to where it was pre-pandemic or possibly something closer to a stagflationary environment. However, it should be noted that the Federal Reserve owns 34% of the entire U.S. Treasury and Federal Agency market, so to say that interest rates are probably not a true gauge of market conditions would be an understatement. Therefore, gauging economic conditions based on interest rates is equally as futile as trying to figure out the consumer.

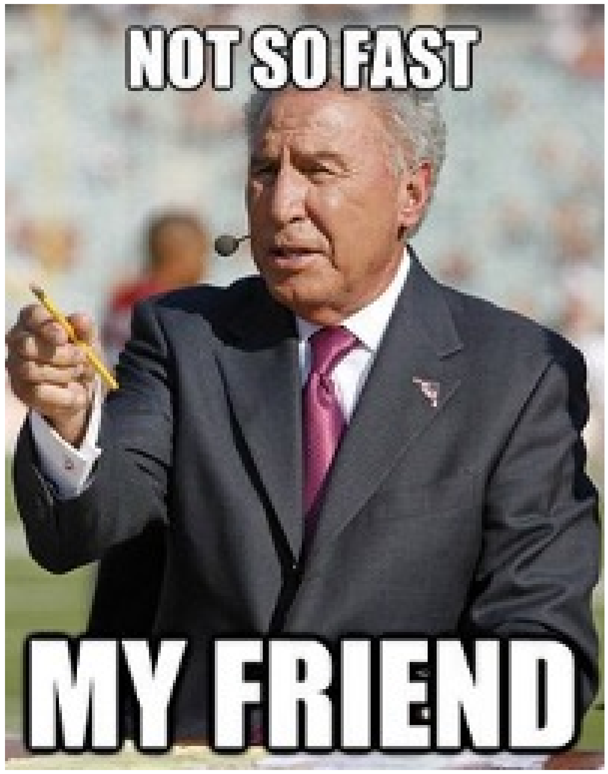
So where does that leave us? It is evident that building a portfolio from the top-down seems increasingly difficult these days. The rotation from value to growth and small-cap to large-cap change not only on a daily basis, but you can see it happen intra-day. Rather than spending a significant amount of time trying to figure out what side of the “style box” to over-and underweight, there is something to be said for owning a portfolio of individual businesses that can consistently grow through any economic cycle. Do not get me wrong, the macro backdrop will certainly affect the fundamentals of all businesses in one way or another. Depending on the environment, growth will accelerate or decelerate, and margins might expand or contract. That said, ownership of well-run companies whose products and/or services are always needed and are not dependent on the economic environment afford you the ability to not have to throw darts at the “style box”.

Dividend Growth

When it comes to a company paying a dividend, the yield should play second fiddle to the growth of the dividend. And it is even more important to make sure the company can justify their dividend growth through actual fundamental growth of the underlying business.

For years we would field questions as to why we did not own AT&T (T) in our portfolio, considering the company was part of an exclusive group called the “Dividend Aristocrats”. To be a part of this “club”, a company must increase its dividend every year for 25 consecutive years. AT&T consistently met this criteria for 35 years until just recently. In December of last year, AT&T made the decision to not raise their quarterly dividend and kept it unchanged from the prior four quarters. Two weeks ago, the company took it one step further and announced a roughly 50% cut in its dividend when they also announced a spin-off of their media segment. And just like that, the Aristocrat status was a thing of the past.

In full disclosure, our reason for not owning AT&T was not because we somehow knew that AT&T would slash its dividend one day. We never owned AT&T because its dividend growth never seemed to be justified by fundamental business growth. Over the past 10 years, AT&T increased its dividend per share by an annualized 1.9%. At the same time, revenue, EBITDA, and operating cash flow increased by an annualized 2-3%. Net income fared much worse, ending last year lower than it was 10 years ago. One might see the 2% cash flow and EBITDA growth and make the point that even though growth is meager, the 1.9% dividend growth is still justified by its fundamentals. However, as Lee Corso so animatedly says:

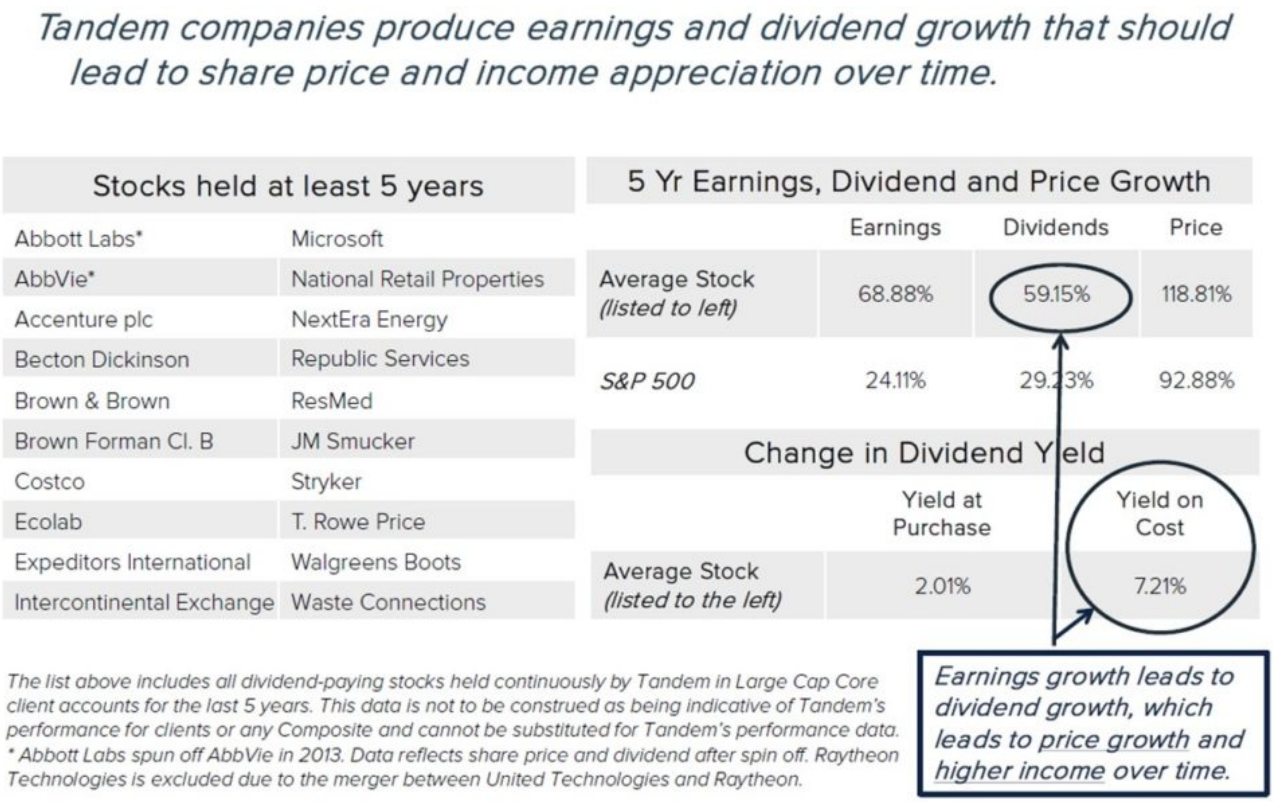


Since 2010, AT&T has made $93 billion in net acquisitions, while their long-term debt has swelled by 111% to $117 billion. So, for $93 billion and an extra $117 billion in debt, AT&T was able to gain an additional $45 billion in revenues, $15 billion in EBITDA, and $8 billion in cash flow. It does not take a significant amount of analysis to quickly see that AT&T's underlying business is not growing and/or their $93 billion in acquisitions has not panned out as expected. Because the dividend growth was not justified by sustainable underlying fundamental growth, the company never met our criteria to be considered as a core holding in our strategies.

I bring up the AT&T example for two reasons. As I mentioned before, we are at a point in this recovery where the economic data is still extremely volatile and Fed intervention within the fixed income market makes it extremely difficult to forecast where we are and, more importantly, where we are going in this economic cycle. Depending on the day, we are either entering reflation, inflation or even stagflation. At the very least, deflation seems to have been taken off the table for the time being. Regardless, I think it is safe to say that consensus is most concerned with an inflationary market environment. Therefore, if we are headed toward a period of sustained inflation, the last thing someone wants, assuming they value the income generated from their investments, is for that income to be fixed. At the very least, you want your income to grow at the rate of inflation to maintain purchasing power.

And ideally, you would invest in a company that grows their dividend at a faster clip than inflation, leading to a positive real return, which is something you cannot get in the Treasury market these days.

The second reason I bring up AT&T is to point out that dividend growth justified by sustainable fundamental business growth is still an important long-term factor in the direction of the asset's price. Many of you have likely seen a slide in our Large Cap Core brochure that highlights the earnings, dividend and price growth of the stocks held continuously for the last five years. A snapshot of this slide is below.



Tandem companies produce earnings and dividend growth that should lead to share price and income appreciation over time.

Stocks held at least 5 years	
Abbott Labs*	Microsoft
AbbVie*	National Retail Properties
Accenture plc	NextEra Energy
Becton Dickinson	Republic Services
Brown & Brown	ResMed
Brown Forman Cl. B	JM Smucker
Costco	Stryker
Ecolab	T. Rowe Price
Expeditors International	Walgreens Boots
Intercontinental Exchange	Waste Connections

5 Yr Earnings, Dividend and Price Growth	Earnings	Dividends	Price
Average Stock *(listed to left)*	68.88%	59.15%	118.81%
S&P 500	24.11%	29.23%	92.88%

Change in Dividend Yield	Yield at Purchase	Yield on Cost
Average Stock *(listed to the left)*	2.01%	7.21%

*The list above includes all dividend-paying stocks held continuously by Tandem in Large Cap Core client accounts for the last 5 years. This data is not to be construed as being indicative of Tandem's performance for clients or any Composite and cannot be substituted for Tandem's performance data. * Abbott Labs spun off AbbVie in 2013. Data reflects share price and dividend after spin off. Raytheon Technologies is excluded due to the merger between United Technologies and Raytheon.*

Earnings growth leads to dividend growth, which leads to price growth and higher income over time.

As a point of reference, over the same five years, AT&T increased earnings and dividends a cumulative 18.22% and 9.47%, respectively, while the stock price declined by 21.97%. AT&T's "growth" was attributable to massive acquisitions and even then, it still lagged that of the S&P 500. Based on the stock price performance and recent decision to slash the dividend, it is very apparent that consistent and sustainable fundamental growth still matters!

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Billy Little is a shareholder, Vice President and Portfolio Manager for Tandem Investment Advisors, Inc. Mr. Little began his career in the investment industry in 2004, as a Financial Advisor with Ameriprise Financial in Baltimore, Maryland. Mr. Little joined Tandem in 2006 where he directs Tandem's quantitative research. He is a regular member of the CFA Institute and past President of the CFA Society South Carolina. Mr. Little graduated from the College of Charleston with a Bachelor of Arts in Business Administration with a concentration in Finance.

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